



Insights: Transfer Pricing

CRA Charles River
Associates

January 2014

Trends in transfer pricing in 2013 and looking ahead to 2014

In 2013, transfer pricing continued to build off the momentum generated in 2012 and was a hot topic of discussion in both the media and halls of government. The following summarizes what CRA believes to be some of the most interesting events in transfer pricing over the last year.

United States

US Senate Subcommittee on Investigations' "Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.)" Hearing

On May 21, 2013, the US Senate Subcommittee on Investigations held the second part of its hearing on "offshore profit shifting and the U.S. tax code." The Senate subcommittee, led by Senator Carl Levin (D-MI) and Senator John McCain (R-AZ), questioned Professors Richard Harvey and Stephen Shay, representatives from Apple Inc. (Apple), and representatives of the US Treasury Department and the Internal Revenue Service (IRS).

The hearing focused on Apple's tax structure and resulting division of profits. Apple uses a cost sharing agreement between its US parent and Irish affiliate. Under this structure, Apple shares both the financial burden of developing intangible property (IP) as well as the profits associated with that IP. The Senate subcommittee alleged that this cost sharing agreement has shifted more than USD 70 billion of Apple's sales from the US to Ireland. When questioned on this structure, Apple representatives repeatedly made it clear that both the structure and resulting division of Apple profits comply with all US tax and transfer pricing regulations. Apple representatives went on to advocate for US tax reform that would lower the overall corporate tax rates, and make the US a more attractive place to do business.

Concluding the hearing, Senator Levin acknowledged the cost sharing tax structure used by Apple violates no US laws, but alluded to the fact that the subcommittee is still investigating other companies using similar practices. Overall, Senator Levin used this hearing to advocate transfer pricing rule reform, specifically in the areas of Subpart F taxation, "check the box" regulations, and Section 482.

Proposed legislation regarding transfer pricing

In 2013, there were three proposed pieces of US legislation directly related to transfer pricing. These proposals were made by members of the US Senate, the US House of Representatives, and the Obama Administration, underlining that transfer pricing is being increasingly scrutinized on both sides of the aisle. While these proposals change transfer pricing regulations in a variety of ways, the ultimate consequence is the repatriation of profits and migration of IP to the US.

House Ways and Means Committee Chairman, Representative Dave Camp (R-MI), introduced legislation in early June that would reduce the tax rate to a flat 15.0 percent on foreign income attributable to IP.¹ This tax rate could be further reduced by subtracting any credits for foreign taxes paid on the same income.² Questions remain about how this proposed legislation would work with the tax deferral strategies used by many US companies.

Senator Carl Levin introduced a bill named “The Stop Tax Haven Abuse Act” in September 2013, which aims to lower the incentives of moving IP or operations offshore. The proposed legislation contained the following components:³

- Treating companies incorporated offshore but managed and controlled from the US as US corporations;
- Closing offshore swap payment loopholes;
- Requiring annual country-by-country reporting;
- Establishing penalties for hiding offshore holdings and instituting programs for better oversight;
- Eliminating incentives currently available under Internal Revenue Code Section 301;
- Limiting incentives to move IP and related marketing rights offshore;
- Taxing excess profit related to transferred IP;
- Granting the IRS the right to use “common sense methods” to value transferred property;
- Repealing “check the box” and controlled foreign corporation (CFC) look-through rules; and
- Preventing multinationals from using short-term loans as a form of profit repatriation.

Senator Levin estimates that these proposed changes would generate USD 220 billion in tax revenue over the next 10 years.⁴

In addition to the proposed transfer pricing legislation introduced in the House of Representatives and the Senate, the Obama administration introduced several proposals designed to curb current

¹ Aaron Lorenzo, “Camp Signals Support for Taxing Foreign Intangibles Income at 15 percent,” *BNA*, 22 Transfer Pricing Report 217. June 27, 2013.

² *Ibid.*

³ Summary of the Levin-Whitehouse-Begich-Shaheen Stop Tax Haven Abuse Act. September 19, 2013. Accessed January 13, 2014, <http://www.levin.senate.gov/newsroom/press/release/summary-of-the-levin-whitehouse-begich-shaheen-stop-tax-haven-abuse-act>.

⁴ Dolores W. Gregory and Aaron Lorenzo, “Sen. Levin Bill Would Reduce Incentives To Shift Corporate Income to Tax Havens,” *BNA*, October, 3, 2014.

international tax and transfer pricing practices. Similar to Senator Levin's proposed legislation, the first and most significant proposition made by the Obama administration is expanding Subpart F rules to include excess income attributable to IP transferred from the US to a CFC with "low foreign effective tax rates."⁵ This change alone could generate an estimated USD 24 billion over the next ten years. The second proposal is to change the definition of "compensable intangible property" as it is used in the US tax code. Broadening this definition to include goodwill, workforce in place, and going concerns, would increase the value of IP transferred out of the US.⁶ Lastly, the Obama administration has proposed eliminating the current debt-to-equity safe harbor and reducing the CFC adjusted taxable income threshold from 50 percent to 25 percent.⁷ Cumulatively, these changes are estimated to generate an additional USD 30.8 billion in tax revenue over the next 10 years.⁸

Changes within the IRS regarding transfer pricing

The IRS, under the direction of Samuel Maruca, has started to place emphasis on reaching pre-trial tax dispute resolutions and streamlining the application of transfer pricing regulations.⁹ Steps taken by the IRS this year to rework their internal operations indicate that it will be more focused on the enforcement of IP ownership and less on the application of more banal transfer pricing practices, such as the return earned by routine service providers.

One of the IRS initiatives focuses on streamlining the Information Document Requests (IDR) process. To reduce the administrative burden on a company facing such an audit, the IRS officially revised its IDR policy in November, which aims to make the examination process more efficient and transparent.¹⁰ IRS examiners hope to communicate with tax payers on the IDR issues to better streamline requests and increase transparency between the two parties. IRS examiners will determine with the taxpayer a "reasonable timeframe" for the IDR response. If a timeline cannot be agreed upon, the IRS examiner will enforce a date. There are now three stages of IDR enforcement that include:

1. Delinquency Notice, which occurs within ten calendar days if the taxpayer misses an IDR deadline;
2. Pre-Summons Letter, which is issued if the taxpayer does not respond to the Delinquency Notice; and
3. Summons.

⁵ Alex Parker, "2014 Obama Budget: Transfer Pricing Items Unchanged, But Expected to Gain Attention," *BNA*, April, 18, 2013.

⁶ *Ibid.*

⁷ *Ibid.*

⁸ *Ibid.*

⁹ Molly Moses, "IRS Taking 'Big Picture' Approach In Transfer Pricing Cases, Maruca Says," *BNA*, November, 14, 2013.

¹⁰ "Large Business and International Directive on Information Document Request Enforcement Process," IRS. November 4, 2013.

In March 2013, the IRS requested comments on the advantages of safe harbors for distribution functions within the US.¹¹ A distribution function safe harbor allows a low-risk entity engaged in a routine distribution intercompany relationship to earn a profit free from the risk of IRS challenge, if it fell into a predetermined range. Should it be enacted, a safe harbor on routine distribution could greatly reduce the burden on multinationals operating as distributors within the US.

Transfer pricing court cases

As transfer pricing continues to be highly scrutinized, we have seen an increase in court cases involving transfer pricing issues. In 2013, some of the ongoing federal cases include:

- *3M Co. v. Comr.*;
- *Abbott Laboratories v. Comr.*;
- *Altera Corp. v. Comr.*;
- *Amazon.com Inc. v. Comr.*;
- *BMC Software Inc. v. Comr.*;
- *Caterpillar Inc. v. Comr.*;
- *Eaton Corp v. Comr.*;
- *Guidant LLC. V. Comr.*;
- *KGB f.k.a. Infonxx Inc. v. Comr.*;
- *Medtronic Inc. v. Comr.*;
- *Synergent v. Comr.*; and
- *Tyco Electronics Corp v. Comr.*

The outcomes of these cases could have a substantial impact on future transfer pricing positions taken by taxpayers.

Europe

The following is a list of publications written by the Transfer Pricing Practice that covers recent developments in France, Italy, and the UK.

- **France tightens transfer pricing regulations**
CRA Principal, Alberto Pluviano, summarizes several new transfer pricing regulations France introduced in December 2013 and how they could impact groups operating in France. Click [here](#) to read the article.
- **OECD public consultation on transfer pricing topics**
Alberto Pluviano focuses on the key discussions from an OECD public consultation. Click [here](#) to read the article.

¹¹ "IRS Seeks Comments on Bilateral Safe Harbors for Certain Transfer Pricing Issues," IRS. March 15, 2013. Accessed January 13, 2014, <http://www.irs.gov/uac/IRS-Seeks-Comments-on-Bilateral-Safe-Harbors-for-Certain-Transfer-Pricing-Issues>.

- **OECD releases Base Erosion and Profit Shifting (BEPS) Action Plan**
CRA Principal, Paul Wilmschurst, summarizes the 15 actions and their deadlines released by the Organisation for Economic Cooperation and Development on July 19 to address BEPS by multinationals. Click [here](#) to read the article.
- **OECD releases two key transfer pricing documents**
Paul Wilmschurst provides a brief introduction to two key transfer pricing documents released by the OECD on July 30, including a “Revised Discussion Draft on Transfer Pricing Aspects of Intangibles” and a “White Paper on Transfer Pricing Documentation.” Click [here](#) to read the article.
- **Proposed measures to tighten transfer pricing regulations in France**
Alberto Pluviano reviews a report published by the French Ministry of Finance that analyzes the technical issues related to transfer pricing regulation in the French system compared with other countries and proposes new measures that would tighten the French transfer pricing regulations. The report also includes comments regarding permanent establishment issues. Click [here](#) to read the article.
- **Current transfer pricing and international taxation issues in Italy**
Alberto Pluviano and co-author, Paolo de’ Capitani di Vimercale of Studio Uckmar Associazione Professionale, summarize the main lessons learned at an Italian seminar regarding national and international developments in transfer pricing. Click [here](#) to read the article.
- **Taxation of the new digital economy**
Alberto Pluviano summarizes the key elements of a report on the taxation issues of the digital economy and provides comments on the strengths and weaknesses of the report and its possible impact on the ongoing discussion on the taxation issues of the digital economy in France and other countries. To read the article, click [here](#).
- **UK Transfer Pricing and the Tax Avoidance Debate**
In this article, Paul Wilmschurst writes about the main developments in the UK tax avoidance debate and how the UK transfer pricing environment may change as a result of these developments. Click [here](#) to read the article.
- **UK House of Commons debate on corporate tax avoidance**
Paul Wilmschurst provides an overview of the discussion in the House of Commons at the beginning of January 2013. Click [here](#) to read the article.

India

US competent authority announced February 1, 2013 that it will not carry out any bilateral Advance Pricing Agreements (APAs) with India because of a large backlog of double taxation cases, the uncertainty surrounding the treatment of US taxpayers under the Indian APA system, and India’s current policy agenda that is shaping its APA program.¹²

¹² Amrit Dhillon, “After Danilack’s Remarks on Indian APAs, Taxpayers Approaching Program with Caution,” *BNA*, March, 7, 2013.

India narrowed its tolerance band for calculating an arm's length transaction. Where Indian regulations used to provide companies a tolerance band of five percent around the mean, this has been narrowed to one percent for "wholesale traders" and three percent for all other companies.¹³ In September 2013, India issued a circular that raised the threshold for compulsory transfer pricing scrutiny to 150 million rupees (USD 2.3 million).¹⁴ Further, India issued a final version of its safe harbor rules that will allow safe harbors to apply for five assessment years.¹⁵ The safe harbor rules could be used by any routine entity with annual intercompany transactions less than 1 billion rupees (USD 16 million).¹⁶ They provide the safe harbors for the following scenarios:¹⁷

- Information technology enabled services would be eligible to elect an operating profit margin (OM) of 20 percent or greater;
- Knowledge process outsourcing services would be eligible to elect an OM of 30 percent or greater;
- Contract R&D services related to software development would be eligible to elect an OM of 30 percent or greater; and
- Contract R&D services related to pharmaceutical development would be eligible to elect an OM of 29 percent or greater.

Looking to 2014

Despite a global trend of increased government scrutiny, most taxpayers continue to resolve disputes predominantly through negotiations with local tax authorities. Generally, the best preparation a taxpayer can make related to the uncertainty of future transfer pricing regulations is to use the arm's length standard and sound economic principles related to risks and rewards. CRA believes the following changes are likely to be enacted or seriously considered in 2014:

- Given the ongoing discussions on country-by-country reporting and transfer pricing documentation requirements, further guidance should be expected in 2014 from the OECD on its overall position in relation to the development of transfer pricing reporting requirements, including a reporting template.
- Encouraged by BEPS and the OECD White Paper, tax authorities are likely to seek a broader picture of multinational enterprises' transfer pricing arrangements than before, including information on business restructurings and intangible transfers elsewhere in the group that may not have a direct impact on the local operations they are auditing. Ultimately, the OECD White Paper on Transfer Pricing Documentation may lead to a global acceptance of the EU Master file concept as a standard template, including an expectation for more detailed information in some areas.

¹³ Amrit Dhillon, "India Narrows 'Tolerance Band' For Calculating Arm's-Length Range," *BNA*, May 2, 2013.

¹⁴ "India Raises Threshold for Transactions Requiring Transfer Pricing Scrutiny to \$2M," *BNA*, 22 Transfer Pricing Report 688, September 6, 2013.

¹⁵ Amrit Dhillon, "India Raises Threshold for Transactions Requiring Transfer Pricing Scrutiny to \$2M," *BNA*, September 19, 2013.

¹⁶ Entities engaged in routine information technology and information technology-enabled services could have intercompany transactions up to five billion rupees (\$USD79 million).

¹⁷ "Statement by CBDT on Safe Harbour Rules Under Section 92CB of the Act." Central Board of Direct Taxes.

- In general, substance has had different meanings in different contexts in international tax. New rules and guidance that will affect its meaning will almost certainly emerge from BEPS. Whether these will continue to define it narrowly, specifically, and contextually, or if the new rules and guidance will tend towards a more blanket definition of economic substance, will become clearer in 2014. In the last 12 months we have already seen tax authorities challenging what they consider to be insufficient economic substance in tax efficient locations.

The OECD is expected to finalize the project of revision of Chapter VI of the Transfer Pricing Guidelines dedicated to intangibles by September. Even if it still unclear how the OECD will address the fundamental issue of ownership of intangibles and allocation of an intangible related return, it can be anticipated that tax authorities will increase the focus on functions performed and value chain analysis in their audits of transactions involving intangibles.

Contact

Rebel Curd

Vice President, Practice Leader of Transfer Pricing
Pleasanton
+1-925-460-1332
rcurd@crai.com

Gary Chan
Consulting Associate
Pleasanton
+1-925-201-5988
gchan@crai.com

Harrison Vale
Associate
Pleasanton
+1-925-201-5985
hvale@crai.com

www.crai.com/transferpricing



The conclusions set forth herein are based on independent research and publicly available material. The views expressed herein are the views and opinions of the authors and do not reflect or represent the views of Charles River Associates or any of the organizations with which the authors are affiliated. Any opinion expressed herein shall not amount to any form of guarantee that the authors or Charles River Associates has determined or predicted future events or circumstances, and no such reliance may be inferred or implied. The authors and Charles River Associates accept no duty of care or liability of any kind whatsoever to any party, and no responsibility for damages, if any, suffered by any party as a result of decisions made, or not made, or actions taken, or not taken, based on this paper. If you have questions or require further information regarding this issue of *Insights: Transfer Pricing*, please contact the contributor or editor at Charles River Associates. Detailed information about Charles River Associates, a registered trade name of CRA International, Inc., is available at www.crai.com.

